

Embracing Morals in Economics: The Role of Internal Moral Constraints in a Market Economy

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Abstract:

Economists who adhere to the assumptions of homo economicus typically focus on altering external constraints through laws or regulations as the means of eliminating bad behavior. Reaching the optimal solution is simply a matter of having government adjust the price of unwanted behavior through punishments or fines. But Adam Smith highlighted the importance of another type of constraint, the internal moral constraint. In recent years behavioral, experimental, and other economists have documented that people often do not act according the assumptions of the homo economicus model and instead appear to incorporate moral constraints into their decision making process. In light of this growing body of research, this article argues that many economists have placed too much emphasis on external constraints and that more emphasis should be placed on internal moral constraints. After discussing possible sources of internal moral constraints, the paper describes how these constraints can help strengthen cooperation in the short and long run.

Keywords: cooperation, moral rules, moral preferences, side constraints, self-government, self-command, norms

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“Without this sacred regard to general rules, there is no man whose conduct can be much depended upon. It is this which constitutes the most essential difference between a man of principle and honour and a worthless fellow. The one adheres, on all occasions, steadily and resolutely to his maxims, and preserves through the whole of his life one even tenour of conduct. The other, acts variously and accidentally, as humour, inclination, or interest chance to be uppermost.”

—Adam Smith

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1. Introduction

What does it take to bring about a well-functioning market? Almost all economists agree that people should engage in cooperative exchange rather than predation, theft, or fraud, but how to ensure this is a matter of debate. Many neoclassical economists follow Thomas Hobbes and focus on changing legal arrangements to solve prisoners' dilemma situations (Barzel, 2002, Hirshleifer, 2001; Tullock, 1972). Eliminating unwanted behavior is a matter of imposing optimal fines, the "price of an offense" (Becker, 1968, p.262), to alter the costs and benefits of different choices. Buchanan (2003, p.183) argues there must be "an agency that will in some fashion, offer incentives, positive and negative, that will lead participants to respect behavioral constraints." This approach assumes that people are knaves and then seeks to design political and legal institutions that will elicit cooperation even amongst amoral egoists (Brennan and Buchanan, 1985). Notably absent from these scholars' discussions are appeals to morality. As Oliver Wendell Holmes (1897, p.459) wrote, "A man who cares nothing for an ethical rule which is believed and practised by his neighbors is likely nevertheless to care a good deal to avoid being made to pay money and will want to keep out of jail if he can." According to this view, one must assume that people are bad and use the threat of force to make them behave positively.

Yet, economists such as Adam Smith and philosophers such as Immanuel Kant heavily emphasize the importance of another type of constraint: the internal moral constraint.¹ These are the rules that people choose to follow independent of what the law says; they are chosen from within.² Manners, politeness, honesty, and trustworthiness are the most obvious examples of internal constraints

¹ Adam Smith (1759, p.449) used the terms "self-government" and "self-command," and modern psychologists refer to the somewhat parallel notions of "self-regulation" and "self-control" when discussing various types of choices, including moral ones (Duntley and Shackelford, 2008). Kant (1794/1997, p.239) contrasts law, "the totality of all compulsory duties," with "ethics, the totality of non-compulsory duties." Kant (1794/1997, p.80) said, "The motivating ground should be moral. The ground for doing a good action should not be made to lie in the reward...Nor, either, should the ground for refraining from bad actions be made to lie in the punishments; the actions should be refrained from because they are bad." For a discussion of how Kantian ideas can be incorporated into modern economics see White (2004) and Stringham and White (2004).

² I refer to an internal constraint as a constraint that someone has adopted and follows even if they will not receive worldly punishment for breaking it. People might initially adopt or internalize moral constraints because of fear of God or prior upbringing that included external constraints (fear of Dad). As such many things in the world can influence internal moral constraints. But as long as the constraint is not imposed by humans I classify it as an internal moral constraint.

that people adopt independent of external rules. But in areas with external constraints (such as laws against force or fraud), are external constraints the only factor influencing behavior, or do internal moral constraints have an influence too?

Orthodox (although of course not all) neoclassical economists are reluctant to discuss or appeal to moral constraints since they run contrary to many of the basic assumptions of *homo economicus*, rational self-interested man.³ Others may recognize the potential importance of morals, but do not talk about them because they cannot be measured using their scientific method nor can they be easily manipulated using policy. Since many neoclassical economists ignore morality they usually attribute the cooperation they observe to external constraints. But the relative influence of external versus internal constraints is an empirical question that cannot be answered using a priori theory. Many or almost all of the observed differences in cooperation might be attributable to differences in people's internal constraints. Furthermore, whether changes in external constraints or appeals to internal constraints are more effective in influencing behavior is also an empirical question. People who focus solely on external constraints are more likely to believe that changes in laws and regulations (as opposed to changes in morality) are the only way to eliminate opportunistic behavior.⁴

In recent years various behavioral and experimental studies indicate that what I am referring to as internal constraints are not only important, but one of the most powerful methods of inducing

³ Notable exceptions are those economists who accept the *homo economicus* assumptions, but then ask whether self-interested man would choose to have a conscience (Frank, 1987). But, in this perspective morality is not guiding or constraining self-interested man; he is choosing morality for self-interested rather than deontological or virtuous reasons. Certain theorists such as Landsburg (2009) believe that much of what is considered traditional morality can be boiled down to economic motives and Harsanyi (1985, p.48) makes the case that "the various deontological components of morality, such as moral rights, moral obligations, moral rules, and moral duties" are best defended on preference grounds.

In contrast, economists such as McCloskey (2006) argue against attempting to reduce all forms of other regarding behavior to some form of self-interested behavior. Röpke (1960), in his non-Hobbesian moments Buchanan (1994), Rabin (1995), White (2004), and Wight (2005) offer theoretical discussions about the importance of voluntary self-restraint or internal moral constraints. Some economists, such as North (1994, p.360), recognize that "self-imposed codes of conduct" exist, but believe their effectiveness is ultimately limited relative to the importance of external constraints. If one believes that both internal and external constraints can matter at the margin, then at any given time one type of constraint is likely to be binding and the other not. For an overview of economists' treatment of ethics in a market economy, see Den Uyl (2009), Wight (2003), and Zak (2008).

⁴ Consider the popularity of the phrase, "There ought to be a law," which, as of June 2010, appeared on 280,000 webpages.

cooperation. Not everyone behaves morally, but many people do, even in the absence of external constraints. For example, Ariely (2008) finds that starting experiments by asking subjects to think about the Ten Commandments subsequently makes them more likely to tell the truth, a finding obviously inconsistent with the assumptions of *homo economicus*. Although some people clearly behave much less morally than others, this paper will offer reasons why economists should embrace the study internal moral constraints, which is latent or explicit in much of the relatively recent research in behavioral and experimental economics. Internal moral constraints may be given to humans by our creator, they might have come about through evolution, or they might be learned through the process of socialization, education, or religion.

Additional research in this area can provide economists with a better idea of when and why people cooperate, for example, and perhaps suggest ways to utilize internal constraints. For instance, in the short run, if people can associate with others who share similar sets of moral beliefs (and can avoid associating with people who do not) the total amount of cooperation can increase. In the long run, although neoclassical economists often focus on changing external constraints, working to influence internal moral constraints might be a better means of eliciting cooperation. A society in which nobody is honest or respects the property rights of others is unlikely to become a successful market economy no matter how many laws exist.

Even though the *homo economicus* assumption is being overturned by a plethora of research, the normative prescriptions advocated by many economists have not caught up. This article argues that the orthodox neoclassical holdouts should not only embrace studying internal moral constraints, but that many of their normative prescriptions should be reconsidered. Instead of hoping that an external group can “force people to cooperate” (Holcombe, 1987, p.108), a better approach may be to try to bring about changes in internal constraints. Rather than attempting to devise an optimal vector of punishments, advocates of a market economy might better advance their cause by openly studying the moral prerequisites of a market economy.

The article is organized as follows. Section 2 discusses why economic theorists would be wrong to exclusively focus on external constraints. Section 3 discusses the relative importance of internal moral constraints. Section 4 discusses potential sources of moral constraints and ways they can be utilized to elicit cooperation. Section 5 concludes.

2. The limits of external constraints: Why inducing cooperation from amoral egoists is easier said than done

How is cooperation best elicited? A high percentage of neoclassical law and economics scholars focus on changing law (external constraints) above anything else. In the words of Stigler (1970, p.526), “All prescriptions of behavior for individuals require enforcement.” Such scholars would view attempts to rely on people’s morality or self-restraint as futile. For example, Sowell (2002, p.29, 31) describes “human beings as tragically limited creatures whose selfish and dangerous impulses can be contained only by social contrivances,” writing that “man’s nature inherently could not coincide with the social good but must be deliberately subordinated to it.”

In basic law and economics models, inducing amoral people to act in certain ways is simply a matter of government adjusting the marginal payoffs of various choices. The idea is that individuals will respond to changes in punishments, sanctions, or fines just as consumers respond to changes in price (Cooter, 1984).⁵ Since legal rules are akin to prices, government can attain its desired outcome by determining and imposing the vector of optimal “prices” (through sanctions, punishments, or fines) to make amoral men act in a moral way. Government simply needs to fine or punish any unwanted behavior so that it disappears.

Despite the precision of these models, the analogy between budget constraints and legal constraints is far from exact. Buchanan (1994, p. 124) refers to “the standard elementary textbook view,”

⁵ In simple law and economics models, these external constraints are functionally equivalent: making someone pay \$1 to buy an apple is little different than fining someone \$1 for stealing an apple. If the probability of punishment is less than one, the severity of punishment should increase so that the expected value equals the desired price (Stigler, 1970, p.527).

but argues that such “presumptions can be challenged empirically.” To many, questioning the efficacy and importance of external constraints is akin to questioning demand curves or the need for prices. Following Buchanan, I maintain that just because one accepts basic price theory does not mean that one must ignore internal moral constraints or believe that people respond to changes in punishments in the same way as to changes in market prices.

In a complex world the government is not likely to be in a good position to calculate and charge the optimal vector of prices to eliminate unwanted behavior. Williamson (1998, p.20) describes how most people assume “that efficacious rules of law regarding contract disputes are in place and are applied by the courts in an informed, sophisticated, and low-cost way.”⁶ In the real world, transaction costs, knowledge problems, and agency problems make using law difficult. Government does not have perfect information about all potential problems, so asking government to calculate and impose the right vector of “prices” for all possible crimes is a formidable task. As Mises (1920) and Hayek (1945) have pointed out, prices constantly adjust according to market conditions. Countless individuals constantly adjust their behavior with no central authority in charge. Whether government fines need to be updated daily to deal with changing societal conditions or vary from person to person to deal with individual circumstances is entirely unclear (Stringham, 2001). If we do not think government can effectively centrally administer prices for the market, we might want to question whether they can do it effectively for law.

Orthodox neoclassical models often consist of a few variables with well behaved convex curves so there is a simple determinate solution. But the real world is much more complex (Dore and Rosser, 2007). In the real world it is often too costly or impossible for parties engaging in exchange first to specify all of the necessary contingencies in a contract and then to have government enforce them. Barzel (2002) describes how third party enforcement is possible when units of a good are homogenous and easily observable. Exchange, however, often involves goods with bundles of attributes that are not

⁶ Williamson (1998), Ellickson (1991) and others (Stringham and Boettke, 2006) criticize what they call the legal centralism of most law and economics models.

easily specified or verifiable by third parties (Bernstein, 1992). For example, a hotel can sign a contract with guests saying that it promises to provide them with rooms. However, the friendliness of the staff, cleanliness of the room, comfort of the beds, quality of the linens, toiletries, and décor, and other attributes are subjective, important, and cannot be specified easily in contracts or enforced by third parties.⁷ Courts and regulators can only enforce minimum standards of quality, but most of what is important goes way beyond the minimum. In labor contracts this truth is even more evident. Work effort, dependability, timeliness, business acumen, politeness, social skills, honesty, and hygiene can determine how effective someone is at his job. Unless government has the ability to easily observe and enforce these attributes, then external legal or regulatory constraints are unlikely to ensure wanted behavior.⁸

Even if government had the ability to observe all variables and individuals' subjective evaluation of their value, relying on external enforcement is still costly (Clay, 1997, p.503). Government might know about the high likelihood of unwanted behavior occurring (for example, crime in prison), yet still have a limited ability to stop it. In a zero transaction cost world, parties would sign contracts for every agreement, and if disputes arose government would adjudicate the matter. But unforeseen contingencies as well as the costs of writing and enforcing contracts make matters less simple (Tirole, 1999), and businesses cannot rely on government courts reviewing and adjudicating all their dealings.

Even though people make scores of unenforceable agreements, much cooperation exists. In his classic study, Macaulay (1963) documents how businesses usually engage in exchange without formal contracts and solve potential disputes without lawyers or courts. He writes, "law suits for breach of

⁷ None of these examples are meant to prove the existence of internal moral constraints. They are simply mentioned to show that markets rely on mechanisms other than laws or regulations to ensure quality.

⁸ One can observe evidence of this in government agencies, such as the Department of Motor Vehicles, where many workers only do the minimum required by law. If inducing people to be more customer-oriented were simply a matter of law, one would expect bureaucracies with tons of rules to have higher output than the private sector. Of course, they do not. The problem is best summed up in an old saying from the Soviet Union: "We pretend to work. They pretend to pay" (Schiller, 1999, p.110).

contract appear to be rare.” Evidence of Macaulay’s findings surrounds us.⁹ In one’s personal life, unenforceable agreements are nearly ubiquitous. Consider the dozens of agreements that one makes in a given day. What percentage involve actual contracts, what percentage result in conflict, and what percentage are taken to court? How practical or costly would it be to rely on external constraints every time one made an agreement?¹⁰

In a world with perfect information, zero transaction costs, and other, often heroic, assumptions, the solutions are simple. It would not matter if one signs a contract with Mother Theresa or Joseph Ponzi. The morality of one’s counterparty would be superfluous since courts would easily rectify any problems. As a practical matter, however, contracts are imperfect, courts are imperfect, and enforcement is imperfect.¹¹ The market is too big and too complex for the government to police all of it (Stringham, 2005).¹² In the real world forcing amoral or immoral people to act in certain ways is far from easy.

3. The Relative Importance of Internal Moral Constraints

3.1. Reasons why internal constraints exist

Economists who ignore internal moral constraints will underestimate their actual importance. Economic analysis often (although of course not always) assumes that people only cooperate for self-interested reasons. The first and most common type of analysis assumes people only cooperate for fear

⁹ For example, an owner of multi-million dollar paving and grading business once told me, “In the 20-plus years of I have owned this company, I have hardly ever signed contracts with my subcontractors. We only dealt with people we knew and trusted” (Personal interview, Los Gatos, California, January 12, 2006). My experience working at an equity trading desk in 1997-1998 was similar and presumably quite common. We were involved in thousands upon thousands of trades, but when we or our trading partner made an error filling an order, we would always settle the issue (determine who should eat the cost) without taking it to a third party.

¹⁰ Many economists believe that people cooperate because of the shadow the law. Even if one does not go to court on a frequent basis, one has that option, and even with a low probability of detection high enough sanctions can encourage cooperation. Yet in many cases going to court is simply not an option (Ellickson, 1991; Clay, 1997; Stringham 2003; Leeson, 2008) and even here cooperation still exists. In these cases one should definitely not attribute cooperation to the shadow of the law.

¹¹ The world envisioned by legal centralists has many parallels to the perfect competition view of the world. Whether or not these parallels are useful for positive analysis, using them for policy recommendations is problematic.

¹² Even many libertarians, who do not favor government enforcement of contracts, are still caught up in this worldview in which third party enforcement is tantamount. For example, the Tannehills (1970) spend a lot of time describing how private police and courts will solve various problems. Yet, in many ways they invoke a *deus ex machina* solution that assumes that third party enforcement is necessary and efficacious, two tenets of the legal centralist worldview.

of external constraints (Gunning, 1972). A second type of analysis, however, recognizes that external constraints are often lacking and documents reasons why egoists can find it in their interest to follow through on their promises (Telser, 1980; Klein and Lefler, 1981). Economists have documented how parties can use mechanisms such as bonding, reputation, or creatively sequenced exchange to create incentives for contracts to be self-enforcing among egoists.¹³ As important as this research is, people may also cooperate for other reasons than pure self-interest.

Indeed, people appear to cooperate out of a greater sense of justice—that is, they adopt internal moral constraints. Although this view is at odds with orthodox neoclassical economics, Adam Smith and many other theorists hold such a view. In his *Theory of Moral Sentiments*, Smith described reasons why people adopt what I here call internal moral constraints. Smith (1759, p.235) believed, for example, that if we do something that our moral faculties judge as wrong: “Those vicegerents of God within us, never fail to punish the violation of them, by the torments of inward shame, and self-condemnation; and on the contrary, always reward obedience with tranquility of mind, with contentment, and self-satisfaction.” Smith considers these constraints as internal with the only punishments being shame or self-condemnation. The person with a conscience does not want to have to think about the questions, “How can you live with yourself?” and “How can you sleep at night?” Thus, I suggest that most people will not commit crimes such as murder even if they could get away with them. McCloskey (2006, p.498) writes, “The life of man is solitary and poor unless the Max U's cooperate—as in fact experimental subjects do cooperate, because they have been children and have loved someone and are not monsters.”

¹³ Williamson (1983) describes how posting forfeitable collateral or any irrecoverable asset enables parties to make credible commitments when external enforcement is costly or absent. Assets can include bonds held by third parties or one's reputation which becomes worthless if one cheats. Greif (1989, 1993), Clay (1997), and Stringham (2003) document historical examples of reputation mechanisms, which can be bilateral (where the cheated party boycotts the offender) or multilateral (where all other parties boycott the offender). Among close knit groups parties can also use religious or familiar pressure to restrain cheating (Landa, 1994; Bernstein, 1992). Other authors talk about how group identity, cultural, or familial pressures can also constrain economic choices (Putnam, 1993; Akerlof and Kranton, 2000). When many of these factors are absent, Watson (1999, 2002) offers a theory of how parties can start with small stakes in a relationship and gradually increase them over time. And even when people have the ability to use force to expropriate from others, Leeson (2007) shows how the strong can pay for goods before they are produced which gives expropriatees the incentive to produce without having to worry about being expropriated. The major lesson from this literature is that parties have incentives to figure out ways of eliminating cheating.

Of course, not all people care about morality; obviously many people, such as psychopaths, do not.¹⁴ But just because some people lack internal moral constraints does not mean that everyone does or that everyone cooperates only because of fear of worldly punishment. As an empirical matter, the vast majority of people profess to believe in one type of morality or another (Kosmin and Keysar, 2006), and people may act cooperatively because they believe in certain moral deontological rules. People adopt morality for different reasons: a concern with eternal salvation, a belief that aggression is against the nature of man, or a belief in karma or some new age sense of justice. Although the motivations differ, the manifestation of these beliefs is the adoption of internal moral constraints that respect others.

One of the most notable recent economists to highlight the importance of internal moral constraints is James Buchanan. Although his earlier writings focused more on external constraints, some of his later writings indicate that he has moved away from that more Hobbesian, worldview (Buchanan, 2004). Buchanan (1994, p.132) writes:

Much of human activity takes place in a setting described as ‘ordered anarchy,’ by which I refer to the simultaneous presence of apparent order and absence of formal laws governing behavior. How is such ordered anarchy possible?...The answer suggested by my argument here is that interacting parties choose to constrain their separate choices in such as fashion as to create non-intersecting and therefore nonconflictual outcomes.

In this view, internal constraints are potentially more important than external constraints. Such a view contrasts with some of the earlier work by public choice economists, who often explicitly assumed that external constraints are the only possible constraints on human behavior (Buchanan, 1972, 1975; Hogarty, 1972; Tullock, 1972, 1974). Hogarty (1972), for example, argued that in the absence of legal constraints, the world would look like the boys’ society in William Golding’s *Lord of the Flies*, a prison camp during the Civil War, or an experiment in which brown rats bit each other.¹⁵ But an interesting feature of *Lord of the Flies* or experiments finding that rats bite each other is that not only do the subjects lack external constraints, they also lack internal constraints, which is likely the more important factor.

¹⁴ As Thomas Babington Macaulay wrote, “The measure of a man's real character is what he would do if he knew he never would be found out” (Reprinted in Templeton, 1997, p.415).

¹⁵ For a critical evaluation of Hogarty’s analysis, see Storr (2005).

Otteson (2002, p.108) quoting from Smith maintains that one of the important movements from childhood to adulthood involves entering “into the great school of self-command.”

For any given moral choice (such as not choosing or choosing to murder for the sole benefit of material gain)¹⁶ people can act in the following ways: (1) the individual does not consider tradeoffs between morality and material gains (the person whom Adam Smith calls “the man of principle”),¹⁷ (2) the individual adopts moral constraints sometimes, or even almost always, but abandons them at a certain price (what Zamir and Madina [2008] call “threshold deontology”), (3) the individual considers morality valuable but always makes tradeoffs between morality and material gains (the person whom Adam Smith calls “a worthless fellow”)¹⁸ or (4) the individual only considers material gains and never morality (traditional homo economicus).¹⁹ How one models each of the above choices is a matter of debate with some economists advocating modeling internal constraints as constraints and others advocating modeling them as preferences (including multiple preferences).²⁰ Adding moral constraints to a broadly neoclassical model certainly complicates matters and makes many results less clean,²¹ but that fact does not justify ignoring internal moral constraints if they indeed exist. Ultimately how much people follow internal moral constraints is an empirical question. In fact much of the experimental and behavioral findings that contradict orthodox neoclassical theory may be driven by internal moral constraints.

¹⁶ I will let others debate the more complicated lifeboat situations (Rothbard, 1998).

¹⁷ These categories are not meant to be exhaustive, but I think they cover most options. White (2006) describes what can be considered an amended Category 1 where people do not consider the material gains of violating morality, but because of their human imperfection they always have a probability of violating their self imposed rules. White (2010) contrasts this imperfection, which involves a probabilistic weakness of will, with what he calls the corrupted or impure position that intentionally considers the material benefits of violating morality (See Categories 2, 3, and 4).

¹⁸ Cooter (2006, p.1281) models all people as constantly comparing the cost of obeying versus disobeying the law (doing what’s right in Cooter’s model) but defines a good citizen as simply having a positive willingness to pay to obey the law.

¹⁹ White (2010, p.223) writes “depravity (or the “corruption of the human heart”) involves putting aside the moral law altogether.”

²⁰ See Rabin (1995), White (2004), and Zamir and Madina (2008) for a discussion of the potential benefits and drawbacks of each approach.

²¹ As one referee correctly points out, adding internal morals as constraints into neoclassical models introduces “two unknowns into one equation.” This could take the wind out of the sails of the old revealed preference approach, because observed behavior can be attributed to different preferences or different internal constraints. Nevertheless economists such as McCloskey (2006), Rothbard (1962) and Boettke and Coyne (2005) argue that decision-making is more complex than most simple “maximize u” models so economists should not limit themselves (they should not adopt internal constraints here) to theories that can be modeled and generate testable hypotheses.

3.2. Evidence that internal constraints are important

Although no formal body of “internal constraints literature” exists, various sources provide evidence of their importance. Research from neuroeconomics, experimental economics, behavioral economics, psychology, anthropology, and common sense observation indicates that internal moral constraints are important. The following is not meant to be a comprehensive literature review but instead a sampling to show how the topic is being studied by economists from different perspectives.

An examination of history shows that many societies function well even though external constraints are largely absent. For example, Ellickson (1991) describes how cattlemen and ranchers in rural California resolve disputes without any knowledge of or regard for formal law. Ellickson attributes the cooperation to strong norms, such as the desire to be a good neighbor.²² Other studies such as Bernstein (1992) show how cooperation in tightly knit religious communities is prevalent. Powell and Stringham (2009) review many studies documenting people who seem to get along independent of formal rules, but judging to what extent cooperation is motivated by pure self-interest versus moral concerns is often difficult in historical case studies.

Ideally, one could peer into subjects’ brains to discover why they cooperate. Neuroeconomics, which uses magnetic resonance imaging (MRI) to record brain activity as subjects make choices, attempts to do just this. McCabe, Houser, Ryan, Smith, and Trouard (2001) have subjects play trust and reciprocity games in which they can either keep a sum of money or pass some of it on (at which point the amount of money passed on is multiplied) to an anonymous counterpart, either human or computer depending on the experiment, who in turn can keep the money or pass it back. The researchers find that the majority of subjects “consistently attempted cooperation with their human counterpart.” The MRIs show that certain parts of the brain light up when subjects cooperate with people but not when they interact with computers. This is consistent with the idea that people are not always making egoistic

²² Posner (1996) discusses the importance of norms in depth, and Gneezy and Rustichini (2000) provide evidence that introducing fines can actually undermine norms.

calculations; sometimes they may think about the moral way to interact with others. The same part of the brain does not light up among people who do not cooperate. Such findings suggest that people have built in tendencies (whether learned or genetically programmed) to want to cooperate.²³

Research in experimental economics provides a plethora of evidence about people cooperating without external constraints. Even with anonymous interaction and no external constraints attempting to induce cooperation, Smith (1998, p.11) summarizes the findings: “the data strongly reject the game theoretic hypotheses that in a single interactive play of the game subjects will overwhelmingly play noncooperatively.” Smith (2008, p.250) provides a comprehensive summary of the findings in experimental economics and describes how cooperation is common even “in games without a punishment option.” Extending this line of research, Powell and Wilson (2008) set up an experiment in which they did not even give their anonymous subjects the option to engage in productive exchange; subjects could merely do nothing, defend, or plunder. Still, the researchers find that in the absence of rules predation is not ubiquitous.

It is important to know whether people act in ways consistent with morality because of selfish reasons (it pays to be honest) or because they just think it is right. We might also want to know whether people act cooperatively in experiments because they have internal moral constraints or simply care about others' welfare.²⁴ Research in behavioral economics provides insight into these questions. In one study, Ariely (2008, p.195) pays subjects for the number of test questions they answer correctly. After administering the test a number of times he figures out the number of correct answers that subjects can reasonably get. He then gives subsequent subjects (chosen from the same pool of students) the opportunity to grade their own tests, shred their answers, and report their scores. Ariely finds that when this second group is given the opportunity to cheat, the number of reported correct answers increases to an unreasonable level. Subjects in group three also grade their own exams, but before the experiment

²³ Other research in neuroeconomics shows similarly interesting relationships between hormones such as oxytocin and what can be interpreted as virtuous behavior (Kosfeld, Heinrichs, Zak, Fischbacher, and Fehr, 2005)

²⁴ Finding that people act altruistically may be consistent with, but does not prove, the existence of internal moral constraints.

begins he asks the subjects to list as many of the Ten Commandments as they can. Suddenly the subjects do not cheat (their scores are identical as the subjects in group one). Ariely finds similar results when students must indicate that they understand that the study falls within their university's honor system. No changes in external constraints occurred, so what made the students behave more honestly? Were they concerned with Adam Smith's impartial spectator? Bateson, Nettle, and Roberts (2006) conduct another experiment in which they place a picture of a pair of eyes above an "honesty box used to collect money for drinks in a university coffee room." They find that this results in people giving three times as much. Such findings are clearly inconsistent with the assumptions of homo economicus and consistent with the hypothesis that people often have regard for moral constraints. How elastic are these responses, and what are the triggers of internal constraints? A very large amount of research could be done on this subject.

The anthropologist Henrich and more than a dozen collaborators conducted behavioral experiments in 15 small scale societies around the world, and found that people's likelihood of acting socially versus like homo economicus varies across societies. Henrich et al (2005, p.78) write, "We found, first, that the canonical model – based on pure self-interest – fails in all of the societies studied." Regardless of where they were from, people were much less likely to behave opportunistically than orthodox neoclassical theory predicts. But, as one would expect, some people cooperated more than others. One of their most interesting findings is that "the higher the degree of market integration" in a society, "the greater the level of prosociality expressed in experimental games."²⁵ This is consistent with McCloskey's (2006) view that markets make people more moral or perhaps that fence sitters find it easier to act morally in a market economy.

The literature in experimental economics is vast and growing as it should be. These academic studies confirm an important point that most people (except a few economists and paranoiacs) already know: not everyone is out to get everyone else. Of course, exceptions exist, and certain people are more

²⁵ A few explanations are possible for such findings, but they are consistent with McCloskey's (2006) hypothesis that markets "improve our ethics" as well as with the hypothesis that markets require ethics.

likely to lack or be tempted to violate internal moral rules. But this fact actually helps prove the point about the relative importance of internal and external constraints. Consider a place with lots of external constraints but also lots of conflict, prisons. Although prisons are much more policed than the general population (a ratio of 1 prison guard to 3 prisoners is common [Mears, 2004], whereas overall in the United States the ratio of policeman to civilian is 1 to 350 [Dantzker, 2005, p.12]), the rate of crimes such as sexual assaults is upward of 100 times higher inside prisons than outside them.²⁶ Obviously the many external constraints are not enough. A good social scientist would respond that the populations are not similar, but that is precisely the point. Whether they explicitly think about it or not, I posit that most people already consider the importance of internal moral constraints. Would the typical person rather encounter members of a prison gang with lots of police around or members of the Society of Friends (the Quakers) with no police around? I don't know about you, but I would feel much more comfortable around the Quakers. The difference is not external, but internal, constraints.

4. Potential sources of internal constraints and ways they can be used to elicit cooperation

4.1. Sources of internal constraints

Internal moral constraints are important. But where do they come from, and can they be influenced? Several hypotheses consider the source of internal constraints. Adam Smith (1759, p.233) wrote that our moral faculties can be founded upon “reason, upon original instinct, called moral sense, or upon some other principle of our nature.” For authors such as Thomas Paine, what I am calling internal constraints are embedded in human nature. He wrote:

Great part of that order which reigns among mankind is not the effect of government. It has its origin in the principles of society and the natural constitution of man. It existed prior to government, and would exist if the formality of government was abolished. The mutual dependence and reciprocal interest which man has upon man, and all the parts of civilised

²⁶ The Bureau of Justice Statistics reports that among the 1,598,316 people in state and federal prisons in 2007, “the estimated number of incidents nationwide totaled 165,400 (65,100 nonconsensual sexual acts with other inmates and 100,300 incidents of unwilling sexual contact with staff)” (West and Sabol, 2008, p.1; Beck and Harrison, 2007, p.5). Yet, although “total population age 12 or older was 247,290,210” the Bureau of Justice Statistics estimates the number of rape/sexual assaults in 2006 to be 272,350 (Rand and Catalano, 2007, p.3).

community upon each other, create that great chain of connection which holds it together. (1791. p.84)

Modern authors, such as Ridley (1997) use sociobiology to suggest that humans have evolved tendencies to want to cooperate rather than cheat. Henrich (2004) describes how cultural evolution, cultural transmission, and competition within and between groups can lead to groups becoming more cooperative. True, people might cooperate only for self-interested calculating reasons (Axelrod, 1984), but they might also cooperate because doing otherwise would be against their evolved or ingrained psyche. If our genetic makeup or a higher power predetermines our internal constraints, then they are outside human choice.

Other authors focus more on the notion that external factors, such as exposure to ideas, education, or socialization, can influence (although not enforce) internal constraints. Being taught certain moral ideas likely causes many people to internalize them. For example, Röpke (1960, p.104) wrote that the main sources of “self-discipline, a sense of justice” and “firm ethical norms,” are “family, church, genuine communities, and tradition.” Rabin (1995, p.27) also argues that experiences such as “Sunday School and general moral socialization” can prime moral constraints. Psychological research indicates that adult psychopaths and children who have yet to be socialized are more likely to believe in the necessity of external controls. Responsible people, in contrast, realize that they must constrain their own choices.²⁷

In his analysis of Smith’s *Theory of Moral Sentiments*, Otteson (2002) maintains that children gradually learn what is right and wrong by observing how people react to their actions. The infant has less way of understanding how others react to their actions, but as they age children have a better understanding. Otteson (2002, p.108) writes that children favor positive feedback and disfavor

²⁷ Debates about eating fattening foods, drinking alcoholic beverages, or consuming drugs have many similarities to those on morality. On one hand are people who believe that government must regulate, tax, or prohibit certain choices, and on the other hand are people who believe that individuals should be taught to control themselves (Leitzal, 2007).

reprimands so they “first see the need to discipline themselves when they have contact with others.”²⁸ Over time children become better at anticipating how others will react and they learn how to internalize rules of proper behavior. In addition to feedback from parents or specific teachers, positive feedback about adopting internal constraints may come from social norms in greater society.²⁹ Norms are informal rules or customs that usually involve disapproval or extralegal sanctions if violated so they entail a degree of constraint external to the individual.³⁰ As one constantly receives feedback for acting in a certain way it can lead people to internalize the adherence to certain norms and follow them even when they do not face any repercussions.³¹

Along with observing social behavior, religion is another potential influence on internal constraints. Those concerned with the afterlife or cosmic justice often consider how different actions will affect how they are treated later on. Adam Smith (1759, p.233) highlighted the importance of religion when he wrote, “That the terrors of religion should thus enforce the natural sense of duty, was of too much importance to the happiness of mankind, for nature to leave it dependent upon the slowness and uncertainty of philosophical researches.” Smith described how people would look to God to enforce justice. Smith (1759, p. 235) wrote, “Hence we are naturally encouraged to hope for his extraordinary favour and reward in the one case, and to dread his vengeance and punishment in the other.” If one were to model this with game theory, a person’s subjective perceptions of the payoffs include those in the afterlife or influenced by God. People who are concerned about such matters should

²⁸ To the extent that people adopt internal moral constraints out of regards for what other people believe, it can be possible that someone’s declaration of the immorality of something would influence whether an individual thinks something is immoral. Authors such as Cooter (1998) believe that government declaring something wrong by law influences whether someone considers a choice immoral (external constraints could influence internal constraints). In his theory external constraints positively influence internal constraints by getting weak willed people to internalize acting in a constrained way.

On the other hand declaring something by law can also have no effect (or perhaps even the opposite effect). For example, among Americans age twenty even though consuming alcohol is against the law 85 percent of them have (Peele, 2007) indicating that the vast majority do not set their moral compass based on what legislatures declare.

²⁹ Social norms can be considered as occupying the space between internal constraints and external legal constraints since they are external to the individual but they are not enforced by law. I thank an anonymous referee for suggesting this point.

³⁰ Binmore (2010) describes how norms can be strong enough that nobody would consider violating them.

³¹ For example, most American diners follow the norm to tip their waiter even if they are in a new city and do not intend to return to that restaurant. The norm of tipping may be internalized into an internal moral constraint that it would be wrong to accept a service without paying for it.

be less likely to commit immoral acts even if they could get away with them. To authors such as John Locke, the importance of religion was tantamount. Locke (1689, p.47) wrote, “Promises, covenants, and oaths, which are the bonds of human society, can have no hold upon an atheist.” Kosmin and Keysar (2006, p.xvi) report that 91 percent of Americans profess a belief in God, so religious beliefs likely affect the choices of many people. Yet, even people who do not accept traditional religion often believe in some sense of justice, so whether one believes in a humanist philosophy, karma, or something else, it still is possible to adopt internal moral constraints. Rosser and Rosser (2009) argue that it makes sense to analyze markets as “embedded within some traditional structure, most likely based on a traditional religion, but also usually emphasizing familistic groupism, which is encouraged by most great world religions.” Economists need not shy away from studying the importance of the religious, social, and cultural factors that make people normal (non-homo economicus) humans.

4.2. Utilizing internal moral constraints when they are fixed

Recognizing that people have internal constraints (and that some people have stronger ones than others) provides people with more options and requires spending fewer resources on enforcement compared to assuming that everyone lacks morals. Buchanan describes how being part of a community where people have strong internal constraints is quite beneficial. Buchanan (1994, p.133) writes, “A community that contains a larger number of members who exhibit a sense of fair play, mutual respect, and reciprocal understanding has less need of formal laws, and can avoid many of the social costs of enforcement by comparison with a community with a larger share of ‘natural criminals.’” Not only does this have implications for an economy as a whole (the more people have internal constraints, the better), but individuals can often benefit personally if they can form individual relationships or opt into communities that utilize internal constraints. If people know they are dealing with others who have similar internal moral constraints, more trusting and less legalistic relationships become possible.

First, let us consider how paying attention to internal constraints is important at the individual level. Homo economicus assumptions notwithstanding, almost everyone recognizes the importance of internal moral constraints when dealing with others. How many people would not care if they found evidence that someone with whom they were interacting lacked morals? How many people would want to take a chance on dealing with someone whom they know to be untrustworthy? In much of the simple economic literature on game theory, people interact with others not of their choosing, and many problems can stem from this. But Tullock (1985; 1999) points out that people usually choose with whom they interact, which translates into much more cooperation than standard theory predicts. Heiner (2002) and Osborne (2005) hypothesize that people can garner information about the trustworthiness of others in their early stages of interaction and thus reduce the likelihood that they will have to deal with cheats.

Although people do not come with labels about their trustworthiness, many proxies can provide information about a person's internal moral constraints. For example, when a banker reviews a loan, he could, but need not, ask "Are you a moral person? Do you believe in fulfilling promises that you make?" Instead, the banker can simply look at a person's credit score. Of course, reliable but amoral borrowers (people who have no qualms about cheating the bank but pay their loan to maintain a good credit score) may exist, but many people repay their loans because they consider it a moral responsibility.

Beyond individual relationships, the creation of informal or formal communities that rely on internal moral constraints is often quite beneficial. For example, in the nineteenth century when London stockbrokers transformed their former main trading venue, a coffeehouse, into a private club, now called the London Stock Exchange, they adopted as their motto, "My word is my bond" (Stringham, 2002). Previously they risked dealing with traders of unknown characters and all sorts of "riff-raff" (Jenkins (1973 p.44), but only trustworthy members were admitted to the club. Similar examples exist all around us: private colleges, country clubs, and firms have selection criteria and background checks to try to

ensure that their members are upstanding.³² People do not want to constantly worry about others stealing their wallet, so many people opt into exclusive clubs where others have similar sets of internal moral constraints.

Only allowing in members is in one sense a privately created external constraint, but once one is inside the college, country club, or stock exchange, even though private rules within the club exist, as a practical matter almost all of the interaction takes place without reliance on formally enforced rules (whether public or private). Rather than figuring out how to create and enforce contracts for the countless numbers of deals that people make within the club (consider how many trades a stockbroker can make in a given day), one can simply focus on determining whether those admitted to the club have an upstanding moral character. These clubs can be formal, with membership requirements (Stringham, 2002), or completely informal, lacking any formal membership requirements or written rules (Stringham, 2003). Certain clubs, such as the diamond bourses described by Bernstein (1992), have religious aspects, which is another way to help ensure that members have similar internal moral constraints.

Rosser and Rosser (1999) present what they call a new traditional economy, which describes how people can adopt a technologically advanced economy while still relying on many aspects of traditional cultures. Many factors in traditional cultures help develop cooperative institutions and likely encourage, strengthen, or utilize internal moral constraints. Rather than designing one size fits all laws based on the assumption that all people lack internal moral constraints, cooperation may be better elicited by letting different groups rely on time tested mechanisms (or attempt to experiment with new ones over time) for eliciting good behavior. Regulations or laws that interfere with group practices can crowd out or undermine private mechanisms for utilizing internal moral constraints.

³² One could argue that by having a door and the option of showing non-cooperative people the door means that clubs are relying on external constraints. In some sense they are, but by establishing a safe environment for their members they create an atmosphere where they eliminate the potential for many conflicts that could have in theory required more external constraints. So one can believe that external constraints are necessary in certain margins, but believe they can be replaced by internal constraints in other margins.

4.3. Influencing internal moral constraints in the short run and long run: The normative economist as social engineer or preacher?

Internal constraints are important in the short run even if they are fixed, but internal constraints are potentially even more important in the long run if they can be influenced. To the extent that moral socialization or economic, ethical, or religious teaching can strengthen internal moral constraints, then helping people do just this could be very important. How much influence is possible is an open question, but the vast majority of parents and educators already implicitly recognize that they need to shape children's internal constraints. Psychologists have documented in depth how self-regulation and self-control are important traits that can be developed (Baumeister and Vohs, 2004), and internal moral constraints are likely quite similar. No one assumes that one can successfully raise children in a box or skip teaching them how to make responsible choices or respect others.³³ If one must be taught how to be a responsible human being, then education and socialization become of utmost importance.

For thousands of years, many religious adherents have focused on spreading commandments such as: "Thou shalt not steal," "Thou shalt not lie," and "Do unto others as you would have them do unto you." It is not difficult to imagine or observe what societies look like when the vast majority of people do not accept those principles.³⁴ They are crucial for any civil society. But how much have people focused on teaching the slightly more advanced ethical norms conducive to a complex market economy? Although billions of people profess belief in the Ten Commandments, it is less obvious to them about whether the implications of these commandments include: "Thou shalt respect other people's private property" and "Thou shalt follow through with one's word in contracts." For good or bad, many religious figures do not focus on those ideas (and sometimes actively argue against them [Woods, 2004]),

³³ Although they skip attempting to raise their child in a box, some parents do engage more in micromanagement or "helicopter parenting," in which they attempt to make or constrain their children's choices, but psychologists criticize this because eventually children will be in positions where they cannot rely on their parents (Fine and Kotkin, 2003, p.262). The parallels with legal centralism are many, except the helicopter parent is replaced by the helicopter state.

³⁴ Crampton (2002) finds evidence that countries where the general public holds views antithetical to markets are more likely to adopt policies at odds with economic freedom, and numerous studies, such as Boettke (1994), Gwartney, Lawson, and Block (1996), and Powell (2008), provide evidence of what happens in countries that lack economic freedom. Boettke (2001, p.248) makes the case that culture determines whether market institutions take hold.

but perhaps economists and others who advocate a free society should. This argument does not imply that betterment of society requires a complete transformation of man; instead it implies that society can be improved at the margin as more people adopt better internal moral constraints.³⁵ Since economic theory is relatively new to the world, should economists spend time studying and teaching the internal moral constraints that help advance markets? Economists such as McCloskey (2006) and Storr (2009) argue that markets help make people more moral. As such it might make sense to incorporate the teaching of economics along with the teaching of ethics whenever ethics are best taught.³⁶

Of course, those who follow Stigler (1982), who criticized “the economist as preacher,” would balk at such an idea. I partially agree with Stigler insofar as I think that plain vanilla positive economics always has a positive role to play. But ultimately I think Hayek (1967, p.281) has it right when he stresses, “why it is most important that a free society be based on strong moral convictions and why if we want to preserve freedom and morals, we should do all in our power to spread the appropriate moral convictions.” One must remember that Adam Smith was not only an economist but also a moral philosopher who taught about the beneficence of markets. Furthermore, although almost all economists believe that trade is mutually beneficial, the same is not true of the general public (Blendon et al, 1997, p.114). As a result, many people do not have what might be considered the proper respect for markets. Given that the public has such different views on trade and many other basic economic subjects (Caplan 2007), perhaps economists should spend more time following George Orwell’s (1939, p.375) recommendation: “The restatement of the obvious is the first duty of intelligent men.” Economists who aim to reform society through changes in rules and regulations may be focusing their efforts in the

³⁵ Knack and Keefer (1997) present evidence that countries with higher overall levels of trust have better economic outcomes, which implies that there is room for improvement across societies.

³⁶ Without further research we do not know the best way of proceeding, but it seems to be mistaken to assume that society can adopt a market economy without an understanding of its ethical underpinnings.

wrong place. Reformers may be more effective at strengthening markets if they embrace studying and discussing the importance of internal moral constraints.³⁷

5. Conclusion

Internal moral constraints are important, yet many or even most neoclassical economists underemphasize or ignore them. Neoclassical law and economics scholars often focus on devising a series of government regulations, punishments, or fines to manipulate amoral egoists into cooperating. These scholars seem to be overemphasizing the importance and efficacy of external constraints. Government enforcement is far from perfect, and despite the less than ubiquitous nature of external constraints, much cooperation occurs. Some of this may be attributable to amoral people deciding that they can gain more by cooperating than cheating, but much is likely attributable to people's internal moral constraints.

Researchers who wish to better understand the world can benefit from embracing the study of the importance of internal constraints. Given that investigations in this topic are relatively recent in the history of economics, many potential research questions present themselves. Future studies could attempt to shed light on the importance of internal constraints compared to external constraints, to devise measures of internal moral constraints, to investigate how differences in internal constraints (between individuals or groups) lead to different market outcomes, and to examine the various factors that influence internal moral constraints, such as upbringing, religion, or socialization. Experimental economics can also be used to study whether certain external factors trigger or strengthen internal moral constraints.

Embracing the study of internal constraints also has potentially important normative implications. In the short run, cooperation might be strengthened as people form relationships or communities with others who have similar internal moral constraints. To the extent that better measures

³⁷ Philanthropist Pierre Goodrich (1961) advocates this strategy; his *Liberty Fund Basic Memorandum* explicitly discusses the importance of moral reform for a free society.

of internal moral constraints can be found, people might actually be able to utilize them, just as bankers utilize credit ratings. In the long run, the entire market economy might be strengthened if we can determine how to positively influence internal constraints. In the past century, and the past few years especially, reformers enamored with external constraints have expanded the number of rules and regulations tremendously. However, economists have shown that regulations are often completely counterproductive (Stigler, 1975; Stringham, Boettke, and Clark, 2008). Rather than devising regulations under the assumption that everyone lacks ethics, it might be more productive to recognize that internal moral constraints exist and to find ways in which they can be utilized or strengthened. Perhaps we should follow Adam Smith, and embrace studying and talking about the moral prerequisites of a market economy.

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